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Wenning Advice

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The arrival of spring isn't the only good news. Like your flowerbeds, the economy is beginning to show signs of life.

However, the economy can be as fickle as the weather and could easily be chilled again or overheated. The economy grew at a rate of 3.5% in the fourth quarter of 2016, but it's been years since we've strung together a couple of quarters of strong growth and Q1 '17 has a projected growth rate of 1.9%. Still, there are plenty of signs that growth will be stronger moving forward.

The stock market, likewise, which had been in an upward trajectory since the election recently hit a rough patch. With efforts to repeal and replace the Affordable Care Act having stalled, things could get rougher.

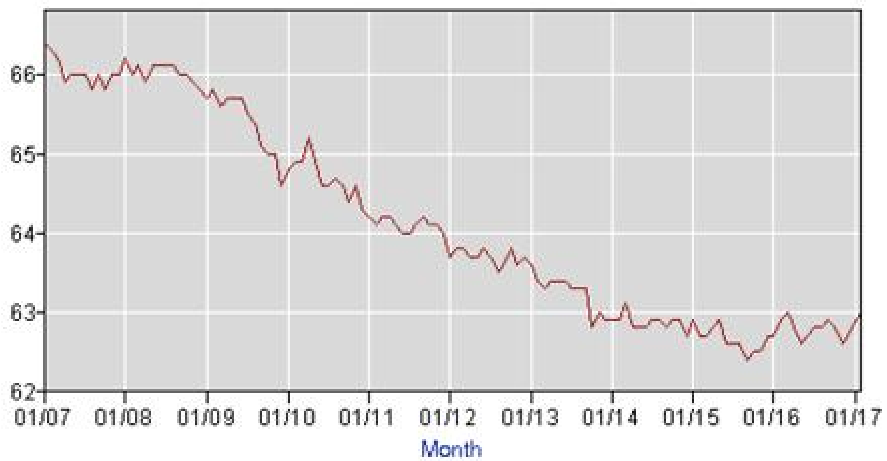
For now, though, consider the good news, which has been a long time coming.

More Work, Better Jobs

The unemployment rate is 4.7% and has been below 5% since May 2016, according to the U.S. Bureau of Labor Statistics, but that doesn't tell the whole story.

As we've previously noted, the U-3 rate goes down not only when people find jobs, but when they give up looking for work. It also counts people who are underemployed in part-time jobs as though they are fully employed. The more accurate U-6 rate, which doesn't fudge the numbers, is still 9.2%. The Federal Reserve Board, various politicians and many economists suggest that we're approaching full employment, but there's still plenty of room for job growth.

And there are other factors that determine the health of the labor market. The labor force participation rate has been close to record lows since the financial crisis, but it has begun showing signs of improvement. In February, it was 63%, which is still well below the pre-financial-crisis rate of 66.4%, but it has been creeping upward since November, when it was 62.6% (*See chart*).



The Job Openings and Labor Turnover Survey (JOLTS) also showed that the job market is improving. It found that available workers per job opening dropped to 2.38 in January, which matches the cycle low and is well below the pre-recession average of 3.32.

Churning Along

Another important factor for the labor market is job churn, which is the gross flow of hirings and separations. As Hedgeye recently noted, "a hallmark of an efficient and well-functioning labor market is a fluid flow of workers - job openings and the creation of new positions is a direct measure of the economy's health (or perceived health), and the more that companies are hiring and creating new positions, the easier it is for job-seekers to find work and for skill and need to find their most productive match. Conventionally, the churn and underlying dynamism of the labor market sits as a proxy for the health of the broader macroeconomy."

In January, 5.44 million people were hired, 1.6 million were laid off or fired, and 3.2 million people quit their jobs. Using total hires and separations to measure churn, a new cycle high of 10.7 million was reached, according to Hedgeye.

In addition, both job openings and the number of people quitting their jobs are at cycle highs, Hedgeye reported.

Meanwhile, the number of Americans filing for unemployment benefits has been falling. The Labor Department reported that initial claims dropped by 2,000 to a seasonally adjusted 241,000 for the week ending on March 11.

Also, non-farm payroll in the U.S. increased by 235,000 in February, a notch short of January's 238,000 increase, but well above expectations of 190,000 new jobs.

If these trends continue, employers will be under pressure to increase wages so they can retain existing employees and attract new, talented workers. When employees earn more, their confidence increases and they spend more, which stimulates economic growth.

Back to Work

In addition, more people working means less strain on government spending on programs that support the unemployed.

In recent years, there has been a disturbing trend of Americans in their prime working years leaving the workforce as a lifestyle choice.

Nicholas Eberstadt, author of *Men Without Work: America's Invisible Crisis*, found that only 84.3% of men aged 25 to 54 were working in 2015, compared to 94.1% in 1948, a decrease of more than 11%. The numbers

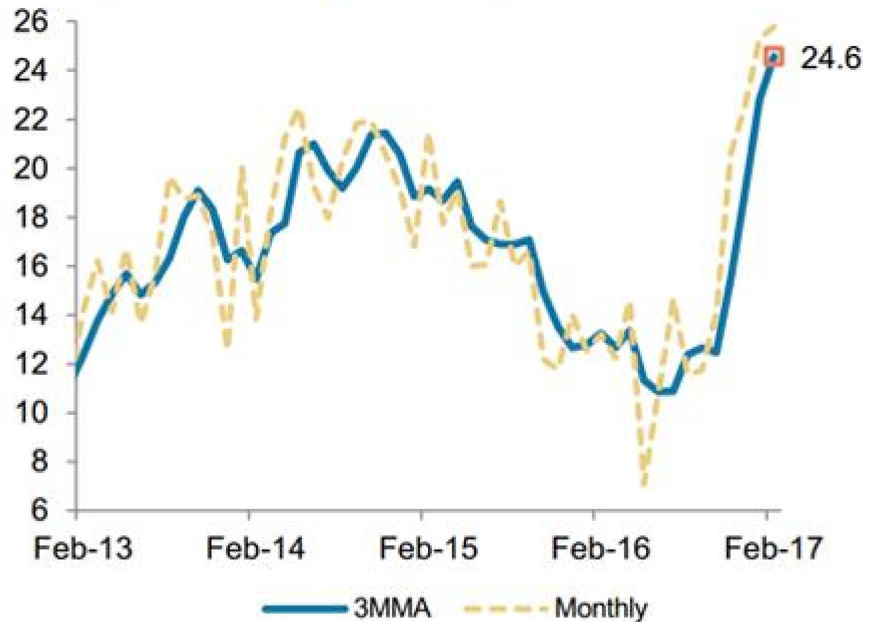
are even more astounding for men 20 and older - only 68.2% worked in 2015, compared to 85.8% in 1948, which is a 25.8% drop.

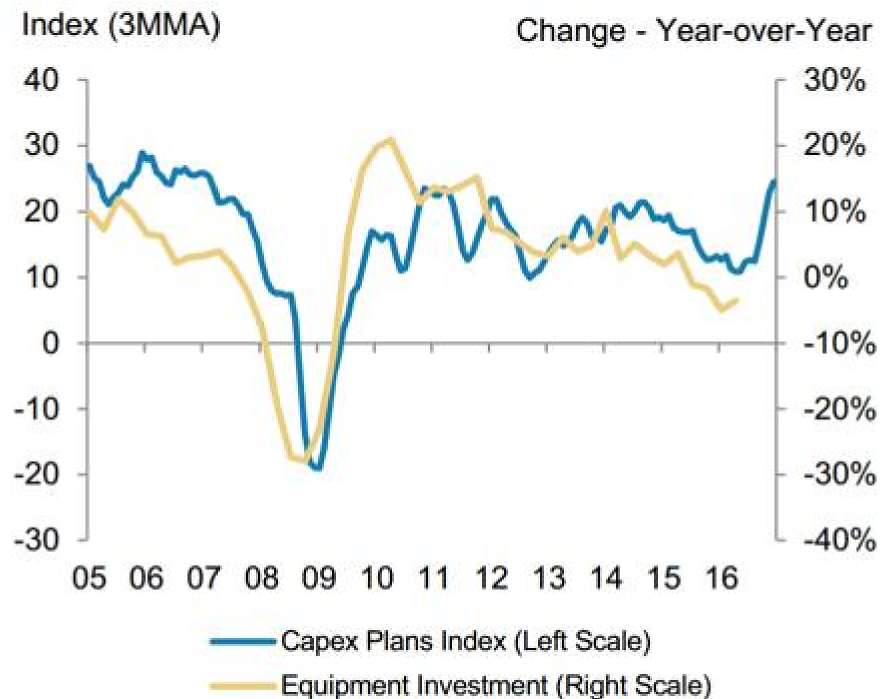
Other Economic Positives

The positive news goes beyond the job numbers.

New orders are up. The Philadelphia Fed's new orders index beat expectations and reached 38.6 in March, its highest level in nearly 30 years. It's up from 38.0 in February. In December 1987, it was 39.4. While the index covers only the mid-Atlantic states, it is regarded as an indicator of national activity.

Capital expenditures are up. Morgan Stanley's composite Capital Expenditures Plans Index in early March was tracking at its highest level in more than a decade.





Housing starts are up. With warm weather and high consumer confidence, housing starts increased 3.0% to a seasonally adjusted annual rate of 1.29 million units in February, exceeding economists' expectations. Compared with a year earlier, home building was up 6.2%.

Building of single-family homes surged 6.5% to reach 872,000 new units, which is the highest level of housing started since October 2007.

Will Economic Trends Continue?

Economic performance, like the stock market, has largely been driven by business and consumer expectations that the Trump Administration's deregulation efforts and tax reform will succeed.

That expectation was dealt a significant blow when the House of Representatives recently failed to approve the American Health Care Act, which was supposed to be the first step in repealing and replacing the Affordable Care Act.

As a result, the Affordable Care Act, which is viewed by many to be expensive and burdensome, is likely to remain in place. Failure to approve the AHCA also jeopardizes other deregulation and tax reform efforts, as savings created by replacing the Affordable Care Act were expected to balance the cost of tax reform.

Home Ownership at 50-Year Low

How the housing market will fare this year is also uncertain.

Housing is likely to be affected by rising interest rates and low inventory, which could combine to make housing even more unaffordable. The boost in new housing starts could help, but a warm February was followed by a cold March, so housing starts are likely to drop again.

Meanwhile, inventory remains at historical lows and home ownership in the U.S. has dropped to its lowest level in 50 years. As recently as 2004, 69% of Americans owned homes. As of 2016, only 63.4% were homeowners.

And Then There's the Fed

For the past eight years, the Federal Reserve Board has managed the economy. Whenever the Fed made a decision, it was major news. Even with the Fed repeating its policy statements with few changes from month to month, media hung on those changes and pundits interpreted them (often inaccurately).

Now, though, the central bank is no longer managing our economy. When the Federal Reserve Board announced on March 15 that it would raise the Federal funds interest rate by 0.25%, the news was greeted with a shrug. The interest rate increase was the second in a three-month period, as a 0.25% increase was approved in December.

With rates now at 0.75% to 1%, there's still plenty of room before rates reach normal pre-crisis levels. The Fed continues to be accommodative and low rates combined with lower taxes and less regulation could provide the economic boost that's been so elusive in recent years.

Conversely, after eight years of low rates, normalization is long overdue, but it will be a challenge to continue to raise rates at a speed that creates a soft landing for the economy, especially given that rates have never before been so low for so long.

Discussing the most recent rate increase, SNW Asset Management reported, "Last week the Fed made it clear we are on the road to a normalization of interest rates. It's happening. The Fed's dot pattern shows an expectation of the fed funds reaching 3.0% in 2019. Nobody is surprised. Unemployment is lower, job creation is good and inflation is picking up. However, while we are currently pleased the economy is strong enough to warrant normalization, the end game is that the Fed will eventually want to cool economic growth to keep inflation in line."

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Here's how securities have performed so far in 2017.

Index	Ticker	3/31/2017
S&P 500	$INX	5.53%
Dow Jones Industrial Average	$INDU	4.56%
Russell 2000	$RUT	2.09%
International ETFs		
Emerging Markets	EEM	12.51%
MSCI EAFE	EFA	7.90%
Europe	IEV	7.83%
Japan	EWJ	5.40%
Latin America	ILF	14.97%
Bond ETFs		
1-3 year U.S. Treasury	SHY	0.80%
3-7 Year U.S. Treasury	IEI	0.44%
7-10 Year U.S. Treasury	IEF	0.73%
20+ U.S. Treasury	TLT	1.33%
US Agg Bond	AGG	0.40%
Investment Grade Bonds	LQD	0.44%
High Yield Bonds	HYG	1.42%
Yield Reaching		
US High Dividend Equity	DVY	2.86%
Lev Loans	BKLN	-0.43%
Utilities	XLU	5.64%
High Dividend Global	SDIV	3.03%
MLPs	AMLP	0.87%
Alternatives		

Where to Invest

In our last issue of *Wenning Advice*, we noted that stock valuations were extremely overvalued. Shiller's cyclically adjusted price/earnings ratio (CAPE), which since 1870 has averaged 16.7 for all stocks, had rocketed to 27.2, putting stock prices as a ratio to earnings in the 95th percentile.

Since then, the CAPE has risen to 28.76. With the CAPE at that level, caution is warranted when investing in stocks.

In spite of the high ratio, we expected stock prices to continue rising during the early days of the Trump presidency and took advantage when we could. Moving forward, volatility is likely to return now that the president's plans for "repeal and replace" have been thwarted. Success with tax reform could boost the market higher again, but currently Congress appears to be too fragmented to expect serious progress.

Short term, though, bonds should pick up the slack, even with interest rates increasing.

As SNW Asset Management noted, "this environment is really quite good for bond portfolios. A measured normalization of interest rates will gradually increase the income in fixed income portfolios with relatively low price volatility."

Even when the Fed raised the Federal funds rate in mid-March, interest rates for bonds from two years to 30 years declined.

"Should normalization continue with long-term rates remaining range bound," SNW Asset Management explained, "this change will be appreciated after the last seven years of the Fed's zero interest rate policy (ZIRP), delivering on hopes for higher income!"

Keep in Touch

Have an idea for a future issue of *Wenning Advice*? Are you interested in active investing or would you like to refer a friend who may be interested?

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